DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

July 24, 2003

The Honorable Don Nickles
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Chairman Nickles:

Thank you for your letter of July 9, 2003, in which you ask for the Treasury Department's recommendations regarding several variations on a transit bond proposal recently reported on by the Congressional Budget Office. Based on our review, the Department opposes these proposals in the strongest possible terms.

In short, as the attachment details, I believe that these proposals represent a grave threat – both themselves and as precedents – to the public fisc and our ability to control spending. These proposals would result not only in ultimately higher costs to the U.S. taxpayer (Treasury's estimates range from $8 billion to $48 billion over 20 years) but also in a threat to the government's financial foundation, which rests upon the soundness of the U.S. Treasury's securities and the confidence the public places in these. We can not allow this confidence to be eroded.

I want to emphasize that these strong objections exist whether the proceeds of these bonds are used to finance mass transit, highways, or any other form of federal spending. If legislation including these or similar proposals were to be presented to the President, I would recommend that he veto the legislation.

I appreciate the opportunity to express the Treasury Department's views on this important legislation. I hope these will be helpful in the Senate's deliberations. If I can provide further assistance on this subject, please contact me.

Sincerely,

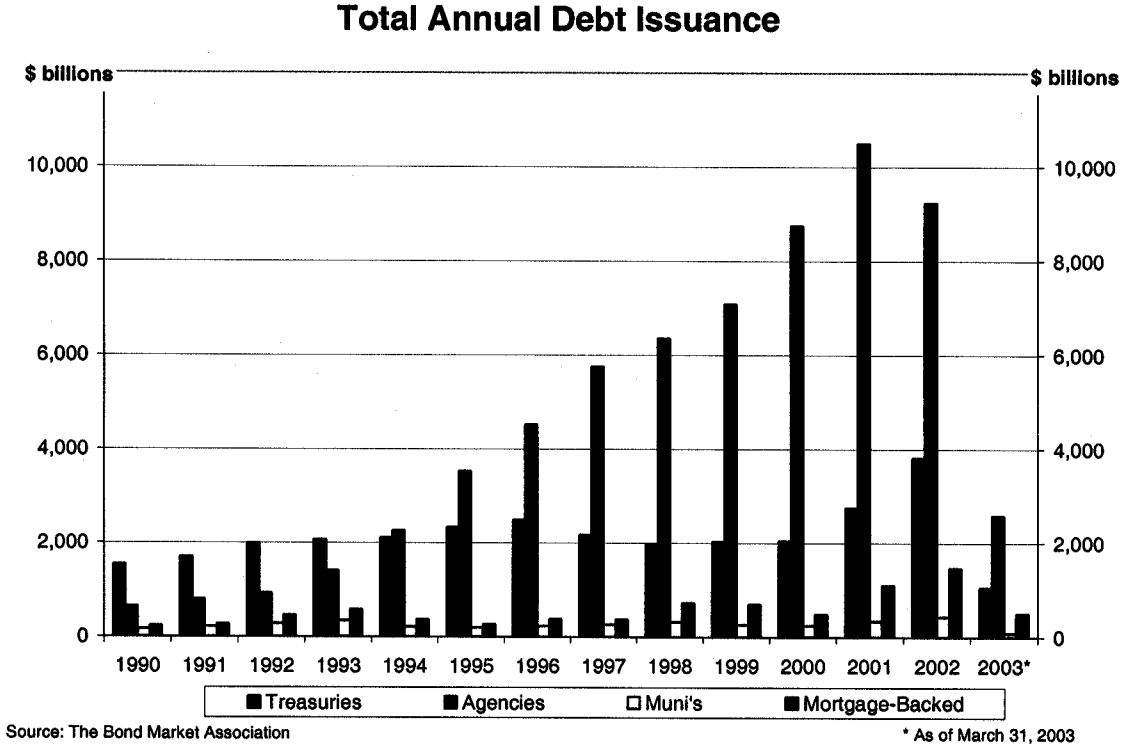
John W. Snow

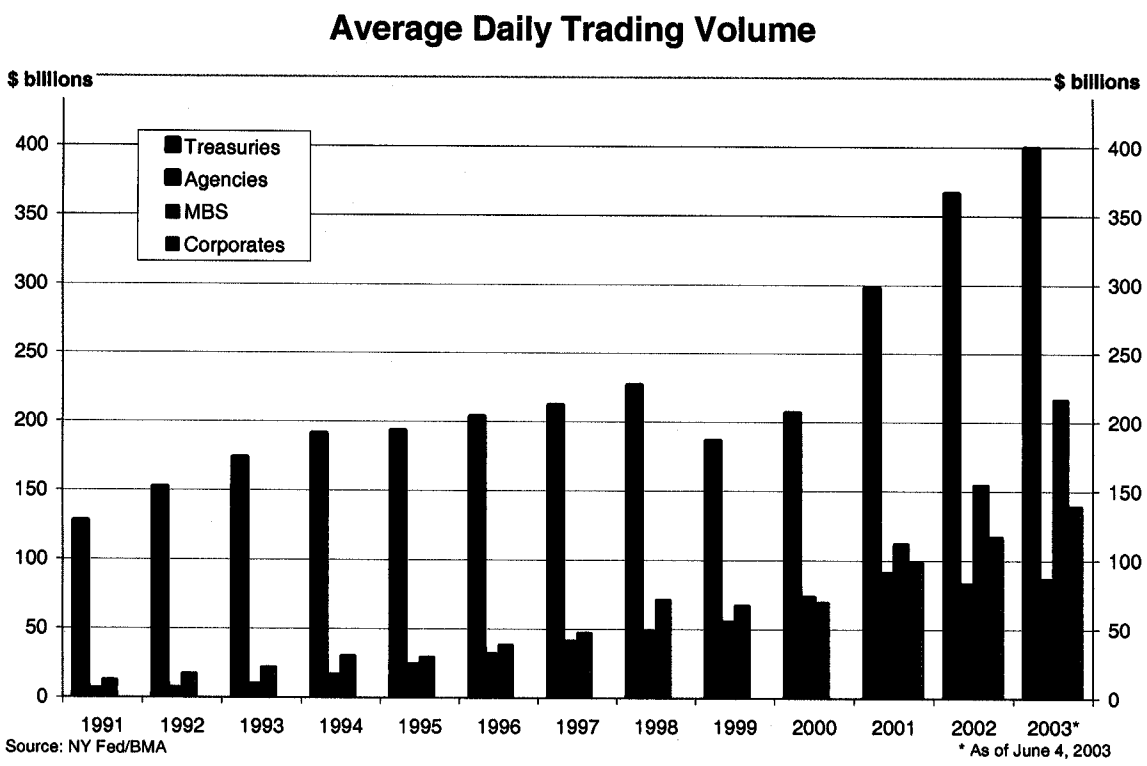
Threat to unitary financing

Treasury objections to this proposal are twofold – one is that any special purpose borrowing would be more costly than unitary financing and the second is that even small changes in market participants' perceptions of Treasury financing principles would generate large costs for a portfolio of marketable debt in excess of $3 trillion. The results of special purpose financing would be unambiguous: the American taxpayer would be worse off.

Special purpose funding for Transportation projects would needlessly burden the taxpayer with billions of dollars in additional financing costs. Assuming a $40 billion, 20 year Highway Bond program, the cost to taxpayers in additional interest cost alone could easily add up to $400 million a year ($8 billion over the life of the program). Potential "contamination cost" to overall Treasury financing could run as high as $2 billion a year in additional interest rate cost. These costs are an unavoidable consequence of special purpose funding: the smaller and more complex a security, the more lenders demand in interest. The costs are potentially so large because of the deviation from the standard Treasury issuance policy, based on the concept of unitary financing, which dates back to the writing of the Constitution.

The US Treasury will auction approximately $3.5 trillion over roughly 190 auctions this year. The US Treasury receives a *liquidity premium* that dramatically lowers government costs. In essence, the marketplace "pays" Treasury to issue debt in such a manner rewarding Treasury for this regular and predictable issuance pattern. The primary and secondary market for US Treasury bills, notes and bonds has no peer. Although issuance of Treasury securities is surpassed by other fixed income issuers, average daily trading volume in US Treasury securities is unsurpassed.

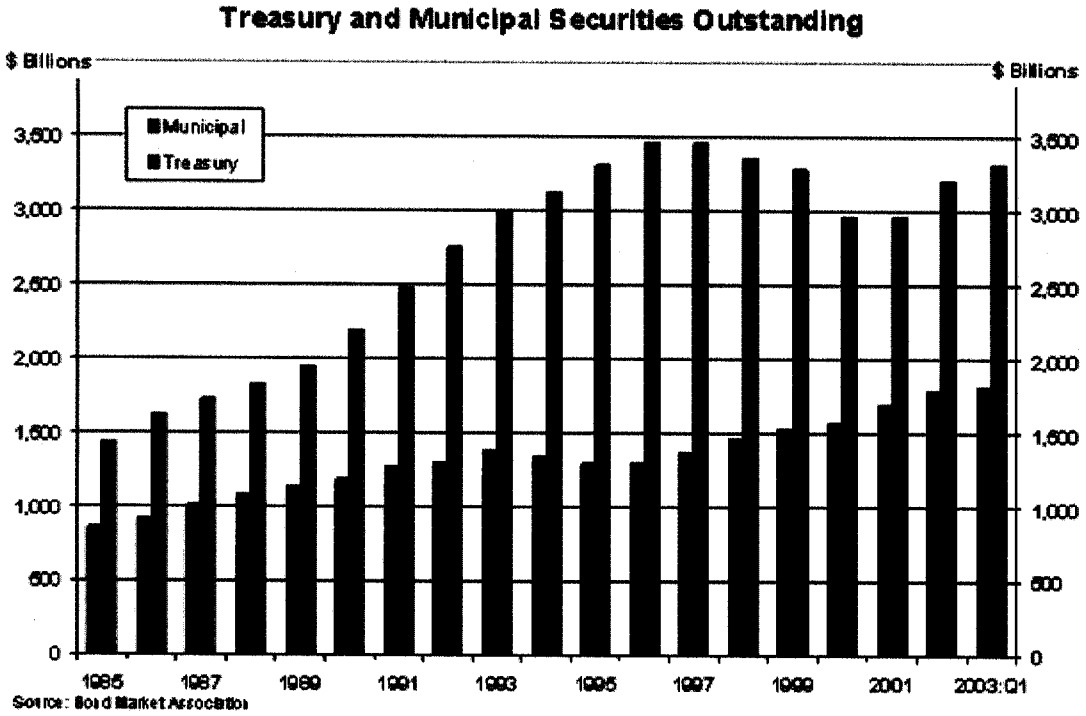


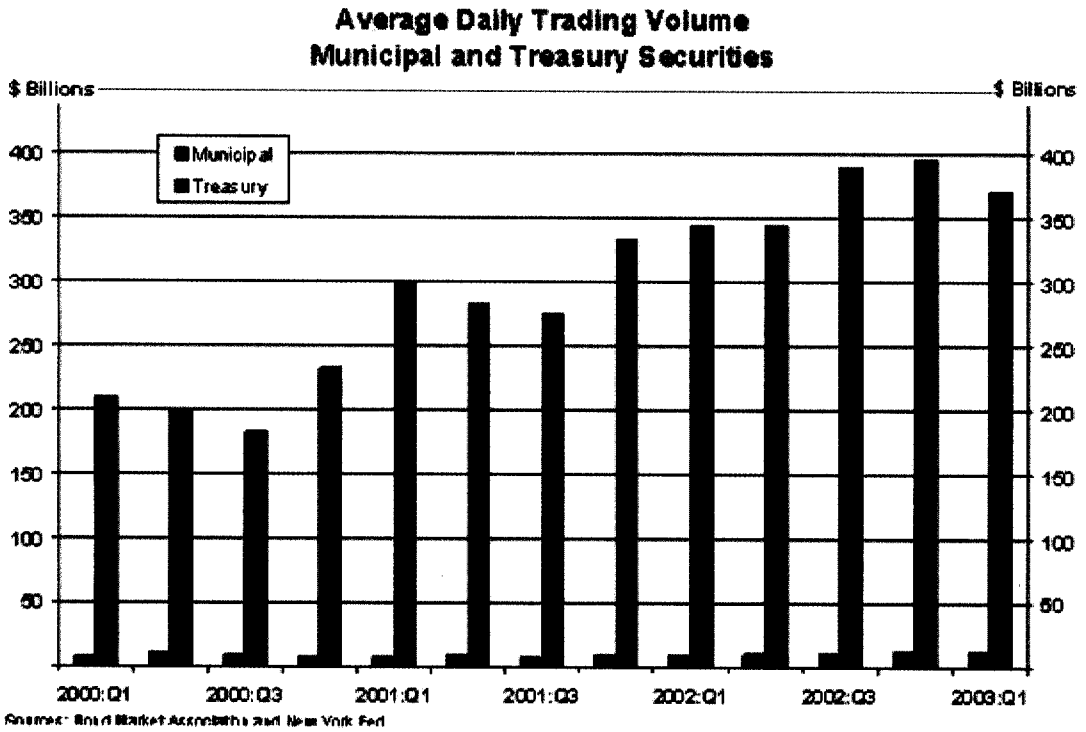


The CBO studied the effects of the Transportation bond proposals and concluded that the costs, depending on approach taken, would be large. Treasury's analysis is consistent with the CBO results but CBO was very careful in making conservative assumptions that, in all likelihood, understate the true costs of special purpose funding. In addition, CBO did not examine the potential costs to Treasury's borrowing for the general fund. Consequently, Treasury estimates that the total cost for this program is significantly higher.

ADDITIONAL CONCERNS WITH SPECIAL PURPOSE BONDS

Illiquidity costs. Small bond issues, with tax treatment that only benefit some investors, reduces the universe of potential investors and the bond's liquidity. To estimate the additional cost of tax-credit bonds, a proper comparison would be the municipal bond market which also caters to tax sensitive investors. While this market is large, liquidity is low due to the small size of individual issues and the limited attractiveness of tax exemption.





Highly rated (AAA) municipal bonds currently trade one percent over Treasury securities after adjusting for tax differences. Taking the one percent as an indication of market demand by tax-sensitive investors, and assuming that the average maturity of the $40 billion in debt is 20 years, the additional cost of lower demand and poorer liquidity would be roughly $8 billion.

Costs to Treasury's regular borrowing program. Investors world-wide may question the United States' commitment to unitary financing if this proposal is enacted. Other agencies would be encouraged to seek independent issuance. Market concerns about agency issuance will increase the borrowing costs for Treasury's general fund. If market participants require just an extra 10 basis points more in interest to compensate them for the increased uncertainty (GSE's trade 10-20 basis points over Treasuries), the federal government's annual interest expenses would increase by $2 billion annually on top of the added expense of the tax-credit bonds themselves.

Special bond issues also raise concerns for Treasury cash management. Unitary financing allows Treasury to raise cash when the government's net cash position is low and better manage cash balances when they are high, such as in tax season. Fragmented borrowing through special purpose bond, would infringe on the Treasury's ability to effectively manage cash balances. If the authorizing legislation restricts the commingling of cash proceeds generated by the sale of these securities from any other receipts of the federal government, then the new securities could require separate and redundant cash forecasting and possible investment functions. This would require large and possibly unneeded investment by Treasury into new systems, further raising the cost of this type of borrowing. This could require Treasury to seek appropriations to staff and develop new protocols and systems. In the current interest rate environment, the cost of carrying excess cash would be at least three percent, i.e., the net difference in the rate Treasury must pay versus what Treasury earns on holding the cash balances. The actual program costs would depend on the structures of the borrowing program and the timing of expenditures.

Retail instruments administrative costs. Some special purpose financing proposals have called for a new retail instrument. Expenses, not including interest, on a $50 bond are over four percent for the administration of retail instruments. So, for example, if the entire program were to be funded at the "retail" level – bonds in small denominations – the administrative cost alone could be $1.6 billion . Congress recently terminated the savings bond marketing program so Treasury no longer has the resources to market such instruments.

Systems programming. Treasury believes the proceeds from an earmarked bond would need to be segregated from other Treasury General Account funds. Permanent changes to cash management systems and reports systems (Daily Treasury Statement, Monthly Treasury Statement of Receipts and Outlays, and the annual Combined Statement of Receipts and Outlays) would require programming time currently estimated at three to 18 months. The new securities would require separate processing flows in the Bureau of Public Debt's systems as well as central agency systems. While not equal to those required for new terms and conditions, system changes could be substantial. Also, most financial publications such as the "Monthly Statement of the Public Debt" would need to be modified to report the securities separately.

Auction costs. If the securities are a new type with different terms, announcement, auction calculation and auction results format there could be significant cost and time involved in modifying the systems that generate auction announcements, accept bids, and calculate and release auction results. If significant changes are required in the offering circular and mainframe and web-based systems involved, it could take as long as six to eight months to make the changes needed to bring a new offering to market.

Treasury would have to determine what changes, if any, would need to be made to the National Book Entry System to allow the proposed security to be traded and transferred. Such an action could also delay and increase the cost of planned upgrades and improvements to the auction-processing systems that support the Treasury's effort to achieve the lowest cost of borrowing.

Summary of Special Purpose Financing Costs (not additive)

Costs of poor liquidity	$400 mill/per year ($8 billion over 20 years)
Costs to Treasury's regular borrowing program	$2 billion per 10 bps annually
Costs of higher cash balances	Depends on structure; at least 3%; as high as $1.2 billion
Retail administrative costs	Depends on scale of retail sales; 4%; as high as $1.6 billion
Systems, programming and auction costs	Largely fixed costs; time to implementation 6 – 18 months

Treasury officials routinely receive advice from market participants on alternative forms of financing. We have seen no evidence that there would be demand for these securities although the investment banks making markets in such securities would undoubtedly profit.

Special purpose bonds issued to finance transportation infrastructure projects are an excessively expensive form of financing that would threaten the Treasury's unparalleled position in the world credit markets, which currently enables it to issue debt at the lowest possible cost. These bonds would lack many of the benefits conferred upon the uniform securities issued by the Treasury and would thus be far more costly to the taxpayer. The issuance of such bonds would also interfere with the Treasury's usual debt management practices, increasing the federal government's interest expenses.

CONCERNS WITH TAX CREDIT-BACKED SPECIAL PURPOSE BONDS

One variation of the proposal to issue special "transit" bonds would involve the issuance of such bonds, the interest on which would be paid by means of a credit against Federal income tax. These so-called "tax credit" bonds would suffer from all the same problems described above with respect to conventional transit bonds, the interest on which would be paid in cash. In addition, however, tax credit bonds would be more expensive to issue, more difficult to administer, and would increase the complexity of the tax law.

Tax credit bonds differ from conventional bonds in that "interest" on tax credit bonds is paid by means of a credit against Federal income tax liability rather than in cash. From a budgetary standpoint, there is virtually no difference between the two types of bonds. Interest paid in cash would be treated as an outlay, whereas a tax credit would be considered to result in lower receipts. In either case, whether issuing a tax credit bond or a conventional bond, the government would incur costs. In addition, there would be increased costs to the IRS of administering any such program.

Payment of interest on such bonds by means of a tax credit would be extremely inefficient. Money is a fungible commodity, whether that money is in the form of a cash payment or in the form of a reduced tax obligation. Tax credit bonds are only useful, if at all, where the tax credit serves as a subsidy for the interest obligation of another party (e.g., qualified zone academy bonds). In this situation, however, it would be the Federal government's own obligation that would be paid by means of a tax credit. Interest payments in cash would be far more efficient and cause significantly fewer collateral consequence.

Moreover, payment of interest by means of a tax credit would be an inappropriate use of the tax code and would add additional complexity to an already overburdened system. The IRS would not have adequate resources to determine whether taxpayers claiming such tax credits were entitled to them. Unless additional resources were allocated for that purpose, taxpayers claiming the credit would, in essence, be on the honor system. The error and fraud rate would increase the cost of the bonds even more. If additional resources were allocated, they would come either from higher appropriations or (more likely) diversion of existing resources away from more effective uses. In either case, there would be additional costs to be borne.